

UNITED STATES OF AMERICA  
POSTAL REGULATORY COMMISSION  
WASHINGTON, DC 20268-0001

Before Commissioners:

Robert G. Taub, Chairman;  
Tony Hammond, Vice Chairman;  
Mark Acton; and  
Nanci E. Langley

Periodic Reporting  
(Proposal Three)

Docket No. RM2018-6

ORDER ON ANALYTICAL PRINCIPLES USED IN PERIODIC REPORTING  
(PROPOSAL THREE)

(Issued July 19, 2018)

I. INTRODUCTION

On June 1, 2018, the Postal Service filed a petition pursuant to 39 C.F.R. § 3050.11, requesting that the Commission initiate a rulemaking proceeding to consider changes to the analytical methods approved for use in periodic reporting.<sup>1</sup> Proposal Three requests the Commission's approval for the Postal Service to enact two separate methodological procedures related to incremental cost estimation. The first procedure would replace the current "hybrid" method for estimating incremental costs, which uses a proxy for international incremental costs, with direct estimation of both domestic and international incremental costs. Petition, Proposal Three at 4. The second procedure

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<sup>1</sup> Petition of the United States Postal Service for the Initiation of a Proceeding to Consider Proposed Changes in Analytical Principles (Proposal Three), June 1, 2018, at 1 (Petition). The proposal is attached to the Petition (Proposal Three).

would create a formula for approximating the data needed to calculate the incremental costs for low-volume products, primarily negotiated service agreements (NSAs). *Id.* at 8, 16. The Postal Service also suggests thresholds for this procedure to exclude NSAs that do not have appreciably different volume-variable and incremental costs. *Id.* at 11-12. For the reasons discussed below, the Commission approves Proposal Three, modified by adding a threshold for procedure two, as proposed by UPS.

## II. PROCEDURAL HISTORY

On June 7, 2018, the Commission issued a notice initiating this proceeding, providing for the submission of comments, and appointing a Public Representative.<sup>2</sup> The Public Representative,<sup>3</sup> the Parcel Shippers Association (PSA),<sup>4</sup> and United Parcel Service, Inc. (UPS)<sup>5</sup> each filed comments on June 29, 2018.

Chairman's Information Request No. 1 was issued on June 13, 2018.<sup>6</sup> The Postal Service responded to CHIR No. 1 on June 20, 2018.<sup>7</sup>

## III. PROPOSAL THREE

The Postal Service proposes two separate methodological changes related to incremental cost estimation. These distinct changes are referred to herein as procedure one and procedure two.

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<sup>2</sup> Notice of Proposed Rulemaking on Analytical Principles Used in Periodic Reporting (Proposal Three), June 7, 2018 (Order No. 4635).

<sup>3</sup> Public Representative Comments, June 29, 2018 (PR Comments).

<sup>4</sup> Parcel Shippers Association Comments on Proposed Rulemaking on Analytical Principles Used in Periodic Reporting (Proposal Three), June 29, 2018 (PSA Comments).

<sup>5</sup> Comments of United Parcel Service, Inc. on Notice of Proposed Rulemaking on Analytical Principles Used in Periodic Reporting (Proposal Three), June 29, 2018 (UPS Comments).

<sup>6</sup> Chairman's Information Request No. 1 and Notice of Filing Under Seal, June 13, 2018 (CHIR No. 1).

<sup>7</sup> Responses of the United States Postal Service to Questions 1-3 of Chairman's Information Request No. 1, June 20, 2018 (Response to CHIR No. 1).

With procedure one, the Postal Service seeks to replace the methodology for estimating the aggregate incremental costs for competitive products. Petition, Proposal Three at 4. The Postal Service's current methodology estimates aggregate incremental costs for competitive products by blending an actual estimate of domestic incremental costs with a volume-variable plus product-specific cost proxy for international incremental costs. *Id.* The Postal Service refers to this procedure as a "hybrid" methodology. *Id.* The Postal Service proposes to replace the current hybrid methodology with the procedure one methodology of direct estimation of both domestic and international competitive incremental costs. In other words, the Postal Service would directly estimate all competitive incremental costs.<sup>8</sup> The Postal Service states that this change will allow it to "rely upon the best available information regarding the incremental costs of all competitive mail for purposes of the cross-subsidy test." Petition, Proposal Three at 7.

Procedure two is a methodology to approximate incremental costs for low-volume products, primarily NSAs.<sup>9</sup> Currently, the Postal Service uses volume-variable costs and product-specific costs to attribute the costs for these products because incremental cost data are not available. A key input in the calculation of incremental costs for a specific product is the proportion of the cost driver caused by that product. *Id.* at 12. These cost driver data are at the cost pool level. However, the Postal Service's data systems cannot distinguish between individual mail pieces entered under an NSA and individual pieces not entered under an NSA at the cost pool level. Thus, "attempting to estimate incremental costs for product groupings or 'product types' that consist partially or entirely of NSA products presents a substantial challenge." *Id.* at 13.

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<sup>8</sup> Incremental costs are sub-additive; the incremental cost of two products is greater than the sum of each product's incremental cost, because these products may have shared costs. See Docket No. RM2016-2, Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three), September 9, 2016, Appendix A (Order No. 3506).

<sup>9</sup> A cost driver is the activity that ties most directly to costs incurred in a cost component. Examples include volume, cubic volume, and weight.

Procedure two produces proxy cost drivers that approximate these required data. More specifically, procedure two uses “the volume variable cost ratio as a proxy for the unknown true variable, the ratio of the cost drivers.” *Id.* at 17.

The Postal Service proposes to use procedure two to estimate incremental costs for NSAs above two thresholds: NSAs with 0.3 percent or more of the product type’s volume-variable cost or NSAs with \$8 million or more in volume-variable cost. *Id.* at 11. The Postal Service avers that its testing revealed that NSAs below either of these thresholds have no appreciable inframarginal costs. The Postal Service comments that calculating the incremental costs for these NSAs “would require a material amount of scarce Postal Service resources, and the resulting incremental cost estimates for those products would not be practically different from their volume variable costs.” *Id.* at 12. The Postal Service contends that “[o]nce the point has been reached . . . where the estimated inframarginal costs already round to zero, further explicit calculations are pointless.” *Id.*

#### IV. CHAIRMAN’S INFORMATION REQUEST

CHIR No. 1 requested that the Postal Service clarify how it constructs its volume-variable costs for NSA products. More specifically, CHIR No. 1 asked the Postal Service to discuss whether it was practical to develop proxy cost drivers for each function, *i.e.*, mail processing, delivery, transportation, and other, to create a more precise estimate of incremental costs. CHIR No. 1 also requested additional information related to Proposal Three under seal.

The Postal Service responded, acknowledging the appeal of “the possibility of more accurate incremental cost calculation,” but stating that “significant computational difficulties would arise in application of the function-level approximation.” Response to CHIR No. 1, question 1. The Postal Service notes that “[f]unctional volume variable costs for NSA products are developed using piggyback factors, which incorporate both direct component costs (such as mail processing labor), and indirect component costs” such that “[a] single indirect component may be split among multiple functions.” *Id.* The

Postal Service concludes that this piggybacking and other issues “make it impractical, if not impossible, to implement the approach.” *Id.*

## V. COMMENTS

The Public Representative, PSA, and UPS each filed comments in this docket. All commenters support Proposal Three.

The Public Representative states that procedure one is “fairly straightforward” and a “clear improvement over the ‘hybrid’ methodology.” PR Comments at 2. She avers that the Commission “should approve” the procedure. *Id.* She also supports procedure two, suggesting that it “is a reasonable way to compensate for the lack of data at the cost pool level.” *Id.* at 2-3. The Public Representative “agrees with the Postal Service that calculating incremental costs for the hundreds of domestic NSAs with minimal volumes is an unnecessary drain on resources” and concludes that “[t]he procedure is designed in a way that no product’s costs would be underreported.” *Id.* at 3.

PSA comments that it “supports both proposals.” PSA Comments at 1. PSA states that calculating NSA incremental costs using proxy data “makes a great deal of sense given that inframarginal costs make up only a very small portion of the incremental cost of individual NSAs.” *Id.* at 1-2.

UPS also comments in support of Proposal Three.<sup>10</sup> In UPS’s view, procedure one represents “a minor improvement over the status quo” and UPS “recommends implementing it.” UPS Comments at 17. UPS cautions that “[t]o the extent errors exist in cost models for international mail, those errors will be ported into this calculation as well” but supports procedure one “as an interim measure in the right direction until a more complete methodology is put in place.” *Id.* at 18. UPS supports procedure two, commenting that it is “imperfect, but represents a small improvement over the status

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<sup>10</sup> UPS’s comments also discuss incremental cost methodology, generally. UPS Comments at 8-16.

quo.” *Id.* at 20. UPS “appreciates that there are genuine difficulties in identifying precise cost driver shares for all NSA products and cost pools” and comments that procedure two “represents an improvement over the approach employed in FY[2016].” *Id.* at 21.

UPS proposes a modification to procedure two in the form of a third threshold. UPS “agrees with the core threshold proposal” but believes that “the thresholds for determining that subset should not be based solely on volume variable cost.” *Id.* at 22. For this reason, UPS suggests that the Postal Service should apply its formula to any NSA with a cost coverage of 105 percent or less. *Id.* at 23.

## VI. COMMISSION ANALYSIS

Based upon a review of the Postal Service’s filing, supporting workpapers, and comments, the Commission approves Proposal Three, as described and modified further below. Pursuant to 39 C.F.R. § 3050.42, the Commission finds that the proposed procedures improve the quality and accuracy of the Postal Service’s incremental costing data, particularly for international mail and domestic NSAs.

*Procedure one.* Procedure one improves the accuracy of the Postal Service’s incremental cost data by replacing the Postal Service’s proxy for international incremental costs with direct estimation for international incremental costs. This improved data can then be used for the Postal Service’s cross-subsidy test, increasing the test’s reliability.

Incremental costs are the costs incurred by providing a product or set of products. The Commission approved the current incremental cost test for competitive products in Order No. 399.<sup>11</sup> At the time, the calculation of incremental costs was only possible for domestic competitive products. The calculation of incremental costs for competitive international products was not possible because the ICRA did not

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<sup>11</sup> See Docket No. RM2010-4, Order Accepting Analytical Principles Used in Periodic Reporting (Proposals Twenty-two through Twenty-five), January 27, 2010 (Order 399).

sufficiently disaggregate between market dominant and competitive products at the cost pool level. Order No. 399 at 3. As a result, the Postal Service used a proxy for international competitive costs that understated the incremental costs of those products.

Procedure one improves this process by calculating the incremental costs for competitive products collectively, substituting a hybrid calculation with a direct estimate of incremental costs for all competitive products.<sup>12</sup> Evaluating the combined cost of supplying both domestic and international competitive products enables the incremental cost test to more accurately measure the cost of providing all competitive products. This improvement is particularly important because certain costs are shared by domestic and international competitive products but not market dominant products.

*Procedure two.* Procedure two improves the quality and accuracy of the Postal Service's incremental costing methodology. The procedure has two components: a proxy cost driver necessary to calculate incremental costs and thresholds at which the Postal Service will use it to calculate incremental costs for NSAs.

The Commission defines attributable costs as the sum of volume-variable costs, product-specific costs, and inframarginal costs, calculated as part of a product's incremental cost. 39 C.F.R. § 3060.10(b)(1). In effect, the incremental cost of a product is its attributable cost.

In Fiscal Year (FY) 2016, the Postal Service began using incremental costs to calculate attributable costs. At that time, the Postal Service could not calculate incremental costs for individual NSAs because it lacked required cost driver data.<sup>13</sup>

The incremental cost module builds on the C Report produced as part of the Cost and Revenue Analysis (CRA) Model, extrapolating the marginal cost data produced in

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<sup>12</sup> This procedure also rectifies the understatement of competitive international product costs by calculating the incremental costs of competitive international mail collectively, a necessary step for calculating competitive product incremental costs.

<sup>13</sup> Docket No. ACR2016, United States Postal Service FY 2016 Annual Compliance Report, December 29, 2016, at 7-10.

the C Report and incorporating group specific costs as appropriate.<sup>14</sup> This calculation is performed at the cost pool level for each product using each product's share of the cost driver for that cost pool to extrapolate the marginal cost data.

The CRA model does not, however, directly develop NSA costs. Instead, the Postal Service applies the function-level volume-variable costs (*e.g.*, processing, transportation, delivery, etc.) developed by the CRA model for each product in the NSA to the volumes reported for the NSA.<sup>15</sup> This is because the Postal Service's data systems cannot distinguish between NSA and non-NSA volumes, a requirement for calculating marginal and incremental costs directly through the CRA model.

For the same reason, the Postal Service cannot disaggregate the share of the cost driver caused by an NSA, which is necessary to calculate incremental costs in the same way they are calculated for other products. To remedy this, the Postal Service has proposed a proxy cost driver for NSAs: the ratio of volume-variable costs for the NSA to the volume-variable costs for the product type (*e.g.*, the ratio of volume-variable costs for Priority Mail Contract 50 to the volume-variable costs of all Priority Mail pieces). This proxy cost driver would be applied to each cost pool for the NSA. Petition, Proposal Three at 13-16.

Developing proxy cost drivers at a function level could result in more accurate cost estimates. Cost drivers based on this more granular data would better reflect the unique functional costs of each NSA. This possibility was investigated in CHIR No. 1.

However, the Commission accepts the Postal Service's explanation that the piggyback factors inherent in function-level costs render this approach infeasible. The Commission acknowledges the difficulties that the Postal Service states are inherent in separating the piggybacked function costs into their respective cost pools. See Response to CHIR No. 1, question 1.

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<sup>14</sup> See Docket No. ACR2016, Library Reference USPS-FY16-43, December 29, 2016; Docket No. ACR2017, Library Reference USPS-FY17-43, December 29, 2017.

<sup>15</sup> See Docket No. ACR2016, Library Reference USPS-FY16-30, December 29, 2016; Docket No. ACR2017, Library Reference USPS-FY17-30, December 29, 2017.



The Commission approves procedure two's proposal to use proxy cost drivers to calculating the incremental costs of NSAs. The procedure will enable the Postal Service to calculate the full attributable costs of NSAs, thereby improving the accuracy of cost attribution and increasing the amount of costs attributed to NSAs, both market dominant and competitive.

The Postal Service plans to employ procedure two to calculate incremental costs for NSAs that meet one of two thresholds: NSAs with at least 0.3 percent of the product type's volume-variable cost or NSAs with at least \$8 million in volume-variable cost. According to the Postal Service, 32 of the Postal Service's 489 domestic competitive NSAs were above at least one of these two thresholds.

These thresholds are reasonable because many NSAs have such low volumes that their inframarginal costs are immaterial. In its response to CHIR No. 1, the Postal Service confirmed the maximum possible inframarginal costs for each product type of NSAs and that these maximum possible costs are immaterial. Response to CHIR No. 1, question 2. Furthermore, the Postal Service calculated the inframarginal costs for the NSAs that would be non-compensatory if the minimum inframarginal cost calculated for a product type was applied to the NSA and confirmed that the actual inframarginal costs for those NSAs are immaterial. *Id.* question 3.

UPS proposes an additional threshold for NSA calculation: any NSA that has a ratio of revenue to volume-variable costs below 105 percent. This additional threshold should not present significant additional burden to the Postal Service.<sup>16</sup> UPS's proposed threshold also helps ensure compliance with 39 U.S.C. § 3633(a)(2) by attributing all costs caused by those NSAs whose cost coverage is at risk of being less than 100 percent, regardless of the amount of cost the NSA incurs.<sup>17</sup> This will provide

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<sup>16</sup> Indeed, as UPS states, the additional computational power for calculating the inframarginal costs of additional NSAs is minimal. UPS Comments at 22 n.48. Most of the additional resources necessary for this threshold would be identifying those NSAs with a cost coverage under 105 percent.

<sup>17</sup> In FY 2017, the number of NSAs meeting this threshold is minimal.

an additional safeguard to ensure that competitive products satisfy 39 U.S.C. § 3633(a)(2).

In conclusion, the Commission approves Proposal Three, encompassing procedure one and procedure two, but modifies procedure two to include an additional threshold, as proposed by UPS.

#### VII. ORDERING PARAGRAPH

*It is ordered:*

For purposes of periodic reporting to the Commission, the changes in analytical principles proposed by the Postal Service in Proposal Three (procedures one and two), with procedure two modified as described in the body of this Order, are approved.

By the Commission.

Stacy L. Ruble  
Secretary